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Stock Options

In July, the Internal Revenue Service proposed regulations that would provide a comprehensive set of rules governing stock options issued under employee stock purchase plans. Earlier in the month, IRS issued proposed regulations relating to ESPP and incentive stock option (ISO) information reporting requirements. In this article, the authors summarize key changes in both regulatory proposals.

Employee Stock Purchase Plans: IRS Update to Rules and Reporting Requirements

By Eric M. Cotts, Louis T. Mazawey, and John McGuiness

Employee Stock Purchase Plans (ESPPs) have been a tax-preferred vehicle for providing equity to employees on a broad basis since Section 423 was added to the Internal Revenue Code in 1964. The statutes governing ESPPs have been amended numerous times over the years. In addition, the regulations and other informal guidance with respect to ESPPs (the ESPP regulations) have also been modified.

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Treasury and the IRS recently proposed a complete update of the ESPP rules.[1] When finalized, the new rules will:

- comprehensively update the existing ESPP regulations to conform them to statutory and other changes that have taken place since 1964;
- make the ESPP regulations more consistent with the regulations governing incentive stock options under I.R.C. Section 422; and
- expand the existing ESPP regulations to provide additional guidance in certain areas, such as employee eligibility, equal rights and privileges, date of grant, option pricing, shareholder approval, maximum aggregate

[1] Employee Stock Purchase Plans under Internal Revenue Code Section 423, REG-106251-08, 73 Fed. Reg. 43,875 (July 29, 2008).

number of shares offered, and the annual $25,000 limitation.

A few weeks earlier, Treasury and the IRS proposed rules that would update the reporting requirements for ESPP and ISO transactions beginning with 2009 transactions.[2]

We review all of these recent developments below.

Background—Taxation of ESPP Options. Ordinarily, the taxation of options granted to employees as compensation for services is governed by I.R.C. Section 83. Under Section 83, options are normally not taxed when they are granted, but are taxed on the ''spread'' when the employee exercises them.

ISOs and ESPP options (statutory options) are taxed under different rules. Statutory options receive special tax treatment under Code Section 421, if they meet certain requirements. Not only is there no income at grant, but there is no income to the employee at the time the statutory option is exercised (unlike under Code Section 83) for the discount element, measured at the time of grant (generally not to exceed 15 percent of fair market value). Taxation occurs later, when the acquired shares are sold or otherwise disposed of. At that time, the discount element is taxed as ordinary compensation income and any additional value is taxed as capital gain. Unfortunately, an employer cannot deduct the compensation element (unlike nonqualified options).

I.R.C. Section 423 provides that the special tax treatment of Section 421 applies to the exercise of an ESPP option if: (i) the stock is not disposed of within two years from the date of the option's grant or within one year from the date of exercise, and (ii) at all times beginning on the date of grant and ending on the day three months before the exercise of the option, the individual is an employee of either the corporation granting the option or a closely related corporation.

The tax code sets forth a number of requirements that must be met for a plan to qualify as an ESPP (many of which are discussed below). Plans that meet these requirements are also exempt from the Section 409A rules governing nonqualified deferred compensation.

Proposed ESPP Regulations. The proposed regulations provide a comprehensive set of rules governing options that are issued under an ESPP, and incorporate substantially all of the rules contained in the existing ESPP regulations. We summarize below the key changes and other guidance.

The proposed ESPP regulations would apply to options granted on or after January 1, 2010. However, they may be relied upon for the treatment of any option issued under an ESPP that is granted after July 29, 2008. Written comments on the proposed regulations are due by October 27.

General Requirements.

■ An ESPP and an offer of stock under the ESPP must be in writing or an electronic form, sufficient to establish its terms.

■ If the terms of a particular option are inconsistent with the terms of the ESPP or an offering under the ESPP (e.g., it is transferable other than as expressly allowed), then the option will not be treated as having been granted under an ESPP, and the special tax treatment of I.R.C. Section 421 will not apply.

■ An entire offering of ESPP options would be disqualified from the special tax treatment of I.R.C. Section 421 where an employee who should receive ESPP options in the offering receives only options with terms that are inconsistent with the terms of the ESPP or with the offering (and so is not treated as having been granted options under the ESPP).

■ The ESPP options in an offering will not be disqualified from the special tax treatment of I.R.C. Section 421 merely because the terms of a compliant option are not satisfied in operation (e.g., a transfer is permitted even though the option terms specify it is not transferable).

Employees Covered Under the Plan. In general, I.R.C. Section 423 requires that an ESPP must be available to all employees of a company participating in the ESPP. Not all members of a controlled group must participate or be taken into account. Also, the following categories of employees may be excluded:

(i) employees who have worked for the employer less than two years,

(ii) employees who customarily work 20 hours or less per week,

(iii) employees who customarily work five months or less per year, and

(iv) highly compensated employees within the meaning of I.R.C. Section 414(q) (HCEs).

The proposed ESPP regulations update these exclusions to conform the regulations to the statute.

The proposed regulations allow ESPPs to exclude subsets of the excludable groups (something that was not clearly permissible in the existing ESPP regulations). Thus, an ESPP may exclude employees who have completed a shorter period of service (i.e., one year) or whose customary employment is for fewer hours per week or fewer months per year than is specified in the statutory exclusions. The regulations also permit exclusion of the following subsets of HCEs: those with compensation above a certain level, officers, or those subject to Securities and Exchange Commission disclosure rules (i.e., Forms 4 and 5 filing requirements). It is important to note that these exclusions must apply uniformly to all employees/HCEs of all corporations whose employees are granted options under an ESPP.

Addressing some open questions, the proposed rules provide that an ESPP may exclude employees who are citizens or residents of a foreign jurisdiction if granting them an option under the ESPP would violate the laws of such jurisdiction, or if compliance with the laws of the jurisdiction would cause the ESPP to violate I.R.C. Section 423. Unfortunately, however, the regulations do not permit the wholesale exclusion of the non-U.S. employees of a participating company. The IRS also rejected requests to permit the exclusion of employees covered by a collective bargaining agreement, citing a lack of statutory authority.

The proposed regulations confirm that if one employee entitled to an option under an ESPP offering does not receive an option, none of the options granted in the offering will be entitled to the special tax treatment under I.R.C. Section 421. However, the IRS invites comments on whether a new correction program that would permit the correction of plan administration errors (e.g., the inadvertent exclusion of employees from

[2] Information Reporting Requirements Under Internal Revenue Code Section 6039, REG-103146-08, 73 Fed. Reg. 40,999 (July 17, 2008).

plan participation) is appropriate, as well as suggestions for the types of violations that might be covered and the methods of correction.

Equal Rights and Privileges. I.R.C. Section 423 and the existing regulations require that, subject to exceptions, an ESPP, by its terms, must provide that all employees granted options under the ESPP have the same ''rights and privileges.'' This requirement is continued in the proposed ESPP regulations.

The proposed ESPP regulations provide that the ''equal rights'' rule is not violated to the extent that employees who are citizens or residents of foreign jurisdictions are offered options under an ESPP with terms that are *less favorable* than those of options offered to U.S. employees because of the legal requirements of such jurisdiction. However, the ''equal rights'' rule will not be met if those terms are *more favorable*.

The proposed ESPP regulations also now permit the carry-forward of certain amounts of unused salary deposits (e.g., due to the $25,000 limit) to a subsequent offering period, as well as fractional shares.

Date of Grant. The date of grant of an option is important in the ESPP context for several reasons:

- favorable tax treatment is only provided where an ESPP option is held for two years from the date of grant;
- the $25,000 annual limitation is determined based on the fair market value (FMV) of the stock measured on the date of grant; and
- the date of grant is used to determine the employees eligible to participate in the ESPP and, in some cases, the purchase price of stock under the ESPP.

The ISO regulations provide that ''date of grant'' and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of a statutory option. The ISO regulations also provide that such a corporate action is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.

Because options under an ESPP may be priced as low as 85 percent of the FMV of the stock at the time the option is exercised, it is not always possible to determine the minimum option price on the first day of an offering. However, many granting corporations intend for the first day of an offering to be the date of grant and use it as such. To resolve this issue, the proposed ESPP regulations provide the date of grant is determined based on the ISO regulations ''corporate action'' test. However, there is no requirement that the minimum option price be fixed or determinable in order for the corporate action constituting an offer of stock to be considered complete. As a result, the first day of an offering could be the date of grant for an option issued under an ESPP even though the minimum option price is not fixed or determinable until the exercise date.

The proposed ESPP regulations also clarify that the date of grant will be the first day of an offering *only if* the terms of an ESPP or offering (i) designate a maximum number of share that may be purchased by each participant during the offering, or (ii) contain a formula to establish, on the first day of the offering, the maximum number of shares that may be purchased by each participant during the offering. An ESPP is not required to utilize these rules, but may do so in order to fix the first day of the offering as the date of grant. Otherwise, the date of grant may not be until the date of exercise when the maximum number of shares purchasable is known.

Option Price. I.R.C. Section 423 provides that the option price under an ESPP option may not be less than the lesser of (i) 85 percent of the FMV of the stock at the time the option is granted, and (ii) 85 percent of the FMV of the stock at the time the option is exercised. Consistent with the ISO regulations, the proposed ESPP regulations would allow the option price generally to be determined in any reasonable manner, including using the valuation methods permitted under the estate tax regulations.

Shareholder Approval. The existing ESPP regulations require that an ESPP must be approved by the shareholders of the granting corporation within 12 months of the date on which the plan is adopted. The proposed ESPP regulations expand the guidance concerning the circumstances under which shareholder approval is required, for example, where there has been a change in the aggregate number of shares that may be issued under the ESPP or the participating companies. They also make clear that shareholder approval is required if there is a change in the underlying shares with respect to which options are issued or a change in the granting corporation. For example, assume that S (a wholly owned subsidiary of P) adopts an ESPP that offers options in S stock to its employees, and that the ESPP is approved in a timely manner by the S shareholders. If S later amends the ESPP to provide for options in P stock (rather than S stock), S must get the approval of the S shareholders (which here is only P). An example in the ISO regulations is contrary to this example; the proposed ESPP regulations also address this by amending the example in the ISO regulations to conform to this result.

The regulations provide additional guidance on the shareholder approval requirements where an ESPP is assumed in connection with a corporate transaction.

Maximum Aggregate Number of Shares. The existing ESPP regulations require that an ESPP designate the maximum aggregate number of shares (MANS) that may be issued under the ESPP. This requirement is continued in the proposed ESPP regulations, which also provide that the ESPP may specify that the MANS may increase annually by a specified percentage of authorized, issued, or outstanding shares at the date of the adoption of the ESPP.

The proposed ESPP regulations also provide that an ESPP that allows for a fluctuation in the MANS for any other specific circumstance will satisfy the requirement in the existing ESPP regulations *only* if the shareholders approve an immediately determinable maximum number of shares that may be issued under the ESPP in any event. Thus, the MANS may not be based on a percentage of shares outstanding as of future dates.

Annual $25,000 Limitation. I.R.C. Section 423 provides that an ESPP must, by its terms, provide that no employee may be permitted to purchase stock under all the ESPPs of his or her employer and its related corporations at a rate which exceeds $25,000 in FMV of the stock (determined on the date of grant) for each calendar year in which an option granted to the employee is outstanding and exercisable. The proposed ESPP regulations provide that the calculation of the amount of stock that may be purchased under an ESPP be determined, to the extent possible, in a manner consistent with the $100,000 limitation for ISOs. The timing of both measures is based on when the options first become exercisable, and both measures are based on the FMV of the stock on the date of grant. Several examples are provided.

Special Rule: Option Price Between 85 Percent and 100 Percent of FMV. I.R.C. Section 423 provides a special rule for calculating the timing and amount of compensation income that must be recognized when the option price is between 85 and 100 percent of the FMV on the date of grant. Generally, the income recognized is the lesser of: (i) the excess of the FMV of the share on the date of grant over the exercise price, and (ii) the excess of the FMV of the share at the time of disposition (or death) over the exercise price. If the exercise price is not known on the date of grant, the exercise price will be determined as if the option were exercised on the date of grant. An example has been added to the proposed ESPP regulations to illustrate how this rule applies under an ESPP that uses a *look-back* feature to determine the exercise price of the option.

Expanded IRS Reporting Requirements for ESPPs and ISOs. The Tax Relief and Health Care Act of 2006[3] amended the information reporting requirements for ESPPs and ISOs under I.R.C. Section 6039. The amendment is effective for stock transfers on or after Jan. 1, 2007. In addition to furnishing a statement to employees with respect to exercises of ISOs under I.R.C. Section 422(b) and discounted ESPP transfers under I.R.C. Section 423(c) (where the option price is generally between 85 percent and 00 percent of the value of the stock), the employer must also file an information return with the IRS in accordance with IRS regulations. However, as the new regulations were not yet issued, the IRS (in Notice 2008-8[4]) waived the IRS filing requirement for 2007.

The IRS recently issued the proposed reporting regulations,[5] summarized below. As anticipated, they largely follow the existing regulations for employee statements, with changes noted below to help the employees calculate their tax obligations upon disposition of the stock (for example, replacing the ''total cost of the shares acquired'' with ''exercise price per share'').

Importantly, employers will meet these reporting requirements (to the IRS and the employee) by using pending IRS Forms 3921 (ISOs) and 3922 (ESPPs). (The methods of delivery of the forms to the employees – either electronic or paper – will be described in the forms' instructions.) Moreover, employers are not required to comply with the IRS filing requirement for 2008 transactions; however, the employee statements – meeting either the existing or the new proposed regulations – must still be provided by the January 31 filing due date (unless extended, also to be described under the pending forms/instructions).

ESPPs. Every corporation which records a transfer of legal title of a share of stock acquired by the employee where the stock was acquired pursuant to the discounted ESPP under I.R.C. Section 423(c) must file a return with respect to each transfer made during a particular year. The return must include:

(a) name, address, and SSN of the employee;

(b) name, address, and EIN of the corporation whose stock is being transferred;

(c) date of grant;

(d) exercise price per share;

(e) date the option was exercised;

(f) fair market value of the stock on the date of grant and date of exercise;

(g) date the legal title of the shares was transferred; and

(h) number of shares of stock transferred.

We note that items (c) – (f) were not previously required, but will apply to the employee and IRS statements.

Under the current regulations, a return is only required for the first transfer of such ESPP shares by the employee (e.g., transfer to broker, or re-title of shares as joint tenants, tenants by the entirety, or tenants in common). In addition, the proposed regulations retain the existing provisions that:

- every corporation which transfers discounted ESPP stock must identify the stock in a manner to enable accurate reporting—e.g., special serial number or color, and
- the employee statement can be made by an authorized transfer agent (as is often the case).

ISOs. Every corporation that transfers stock pursuant to an employee's exercise of ISOs under I.R.C. Section 422(b) must file a return with respect to each transfer made during a particular year. The return must include:

(a) name, address, and EIN of the corporation transferring the stock (and whose stock is transferred, if different);

(b) name, address, and SSN of the recipient;

(c) date of grant;

(d) exercise price per share;

(e) date the option was exercised;

(f) fair market value of the stock on the date of exercise; and

(g) number of shares of stock transferred.

This same disclosure applies to the employee statement.

Comments are specifically requested regarding (i) whether this information is necessary or has practical utility, (ii) the accuracy of the estimated reporting burdens and how to minimize any burdens, (iii) estimates of the costs associated with providing this data, and (iv) how the data collection may be enhanced. The comment deadline is October 15. Hopefully, employers and their agents will be able to make the necessary system adjustments in order to comply for 2009 ESPP and ISO transactions reportable in January 2010.

Observations. The proposed regulations provide some helpful guidance on a number of longstanding issues affecting ESPPs, and should not require major changes in the operation of these plans. The regulations do underscore the need to carefully design the plan and option terms, and to avoid situations where a company may have trouble meeting the rules, for example, because it employs union-represented employees or nonresident aliens.

Companies should review their plans for compliance and also prepare for payroll reporting changes needed to satisfy the proposed rules for ESPP reporting to IRS and employees, scheduled to apply beginning in 2010.

[3] Pub. L. No. 109-432.

[4] 2008-31 I.R.B. 276 (Jan. 22, 2008).

[5] Supra, note 2.